EU fiscal rules:
An assessment of trends and prospects against the backdrop of the ongoing economic governance review

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JVI, 20 March 2023

Disclaimer: Views expressed are not necessarily those of the EFB or the Commission.

Outline

- Scene setter: SGP under review!
- Looking back: Has the SGP worked?
- Looking ahead: some adjustments or a regime shift?

Scene setter

EU economic governance under review

5/2/2020
Evaluation of 2011 und 2013 Reforms of the governance framework: comprehensive results published

19/10/2021
New Commission communication re-launching the review

28/03/2022
Online public consultation: results published

9/11/2022
Latest Commission communication: Orientations for a reform of the economic governance framework

14/03/2023
Council conclusions on the Commission orientations

Scene setter

Review process has taken lots of time

Member States are devided

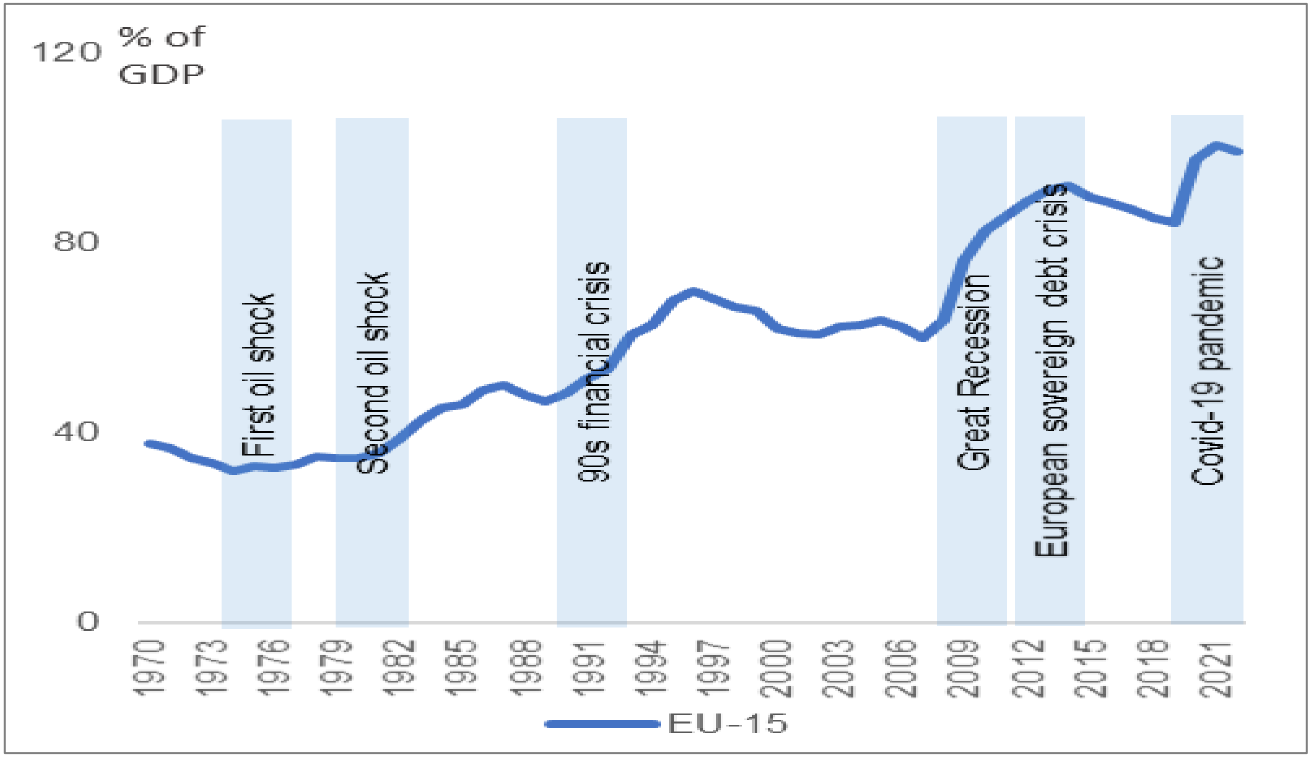
- ‘Frugal north’ vs ‘profligate’ south
- Risk reduction vs risk sharing
- Adjust fiscal policies to rules? vs Adjust rules to new fiscal reality?

Commission orientations imply major change

- No requirements for countries with low public debt challenges (except 3% of GDP reference value for deficit)
- tailor-made and less onerous adjustment requirements for counties with high and moderate public debt challenges => stronger ownership
- Better enforcement in the event of deviations: lower financial sanctions, reputational sanctions and macroeconomic conditionality

A very concise fiscal history of the EU

Ratcheting-up effect: government debt levels increase during crisis but never return to pre-crisis levels.



Note: EU15= BE,DK,DE,IE, EL, ES, FR, IT, LU, NL, AT, PT, FI, SE, UK

Source: European Commission, own calculations

Why EU fiscal rules?

To: M. Lamfalussy

Copy to: Dr. Baer

From: Claudio Borio

Macro-fiscal policy co-ordination in an EMU

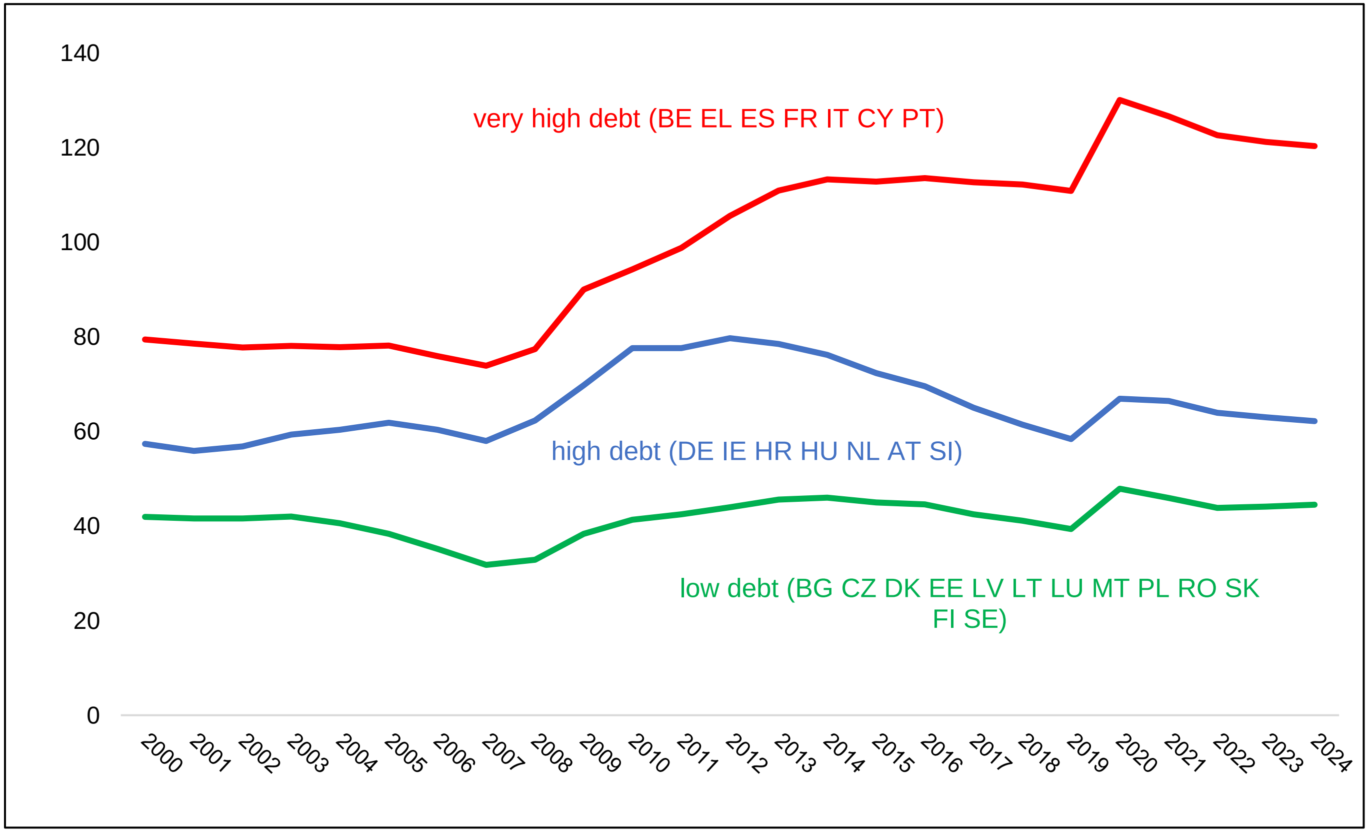
- the need to avoid disproportionate use of Community savings by one country;
- a possible bias towards lack of fiscal restraint;

Source: Archive of the Delors committee:
https://www.ecb.europa.eu/ecb/access_to_documents/archives/delors/html/index.en.html

Looking back

Did EU fiscal rules work?

Gross government debt (in % of GDP)



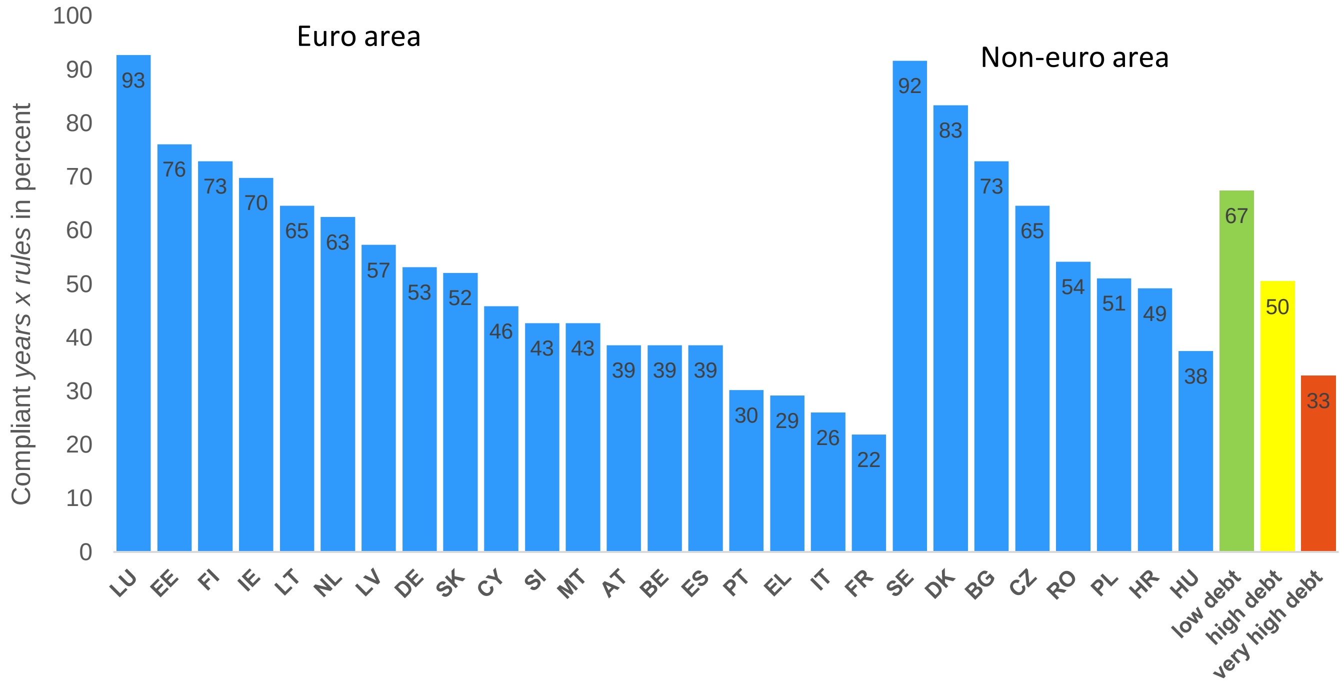
Note: Countries are grouped based on their average debt levels in 2011-2019. Low debt = EU countries with government debt <= 60% of GDP (in 2011-2019 on average). High debt: EU countries with 60% of GDP > government debt >= 90% of GDP. Very high debt: EU countries with government debt > 90% of GDP.

Source: European Fiscal Board

Looking back

Bad luck or bad behaviour?

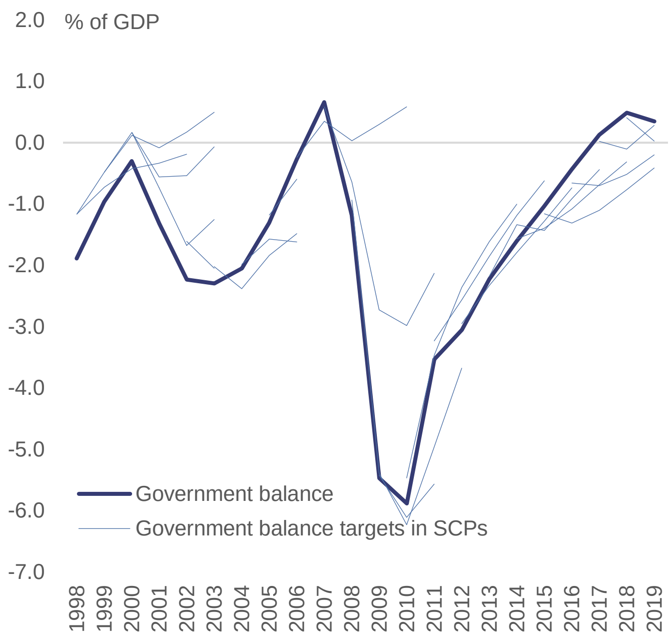
Average compliance score, 1998-2021



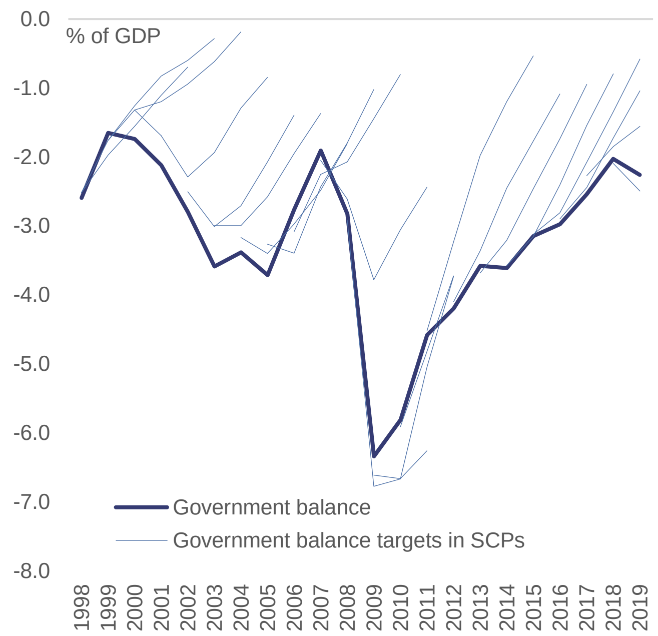
Source: Compliance tracker, Secretariat of the European Fiscal Board

Bad luck or bad behaviour?

Draft budgetary plans vs outcomes (euro area)



(a) Countries with government debt below the EU average in 1998-2019 (75% of GDP): EE, LU, LV, RO, LT, CZ, BG, DK, SL, SK, SE, PL, FI, HR, NL, IE, MT, DE, HU, ES, CY, AT



(b) Countries with government debt above the EU average in 1998-2019 (75% of GDP): FR, PT, BE, IT

Source: European Commission

Bad luck or bad behaviour?

Assessment of draft budgetary plans (euro area countries)

	Ex-ante average deviation	
	SB	EB
BE	-0.4	-0.6
DE	1.4	1.2
EE	-0.1	-0.3
IE	0.1	-0.1
ES	-0.7	-1.2
FR	-0.6	-0.7
IT	-0.8	-0.8
CY	0.2	-0.1
LV	0.0	-0.6
LT	0.4	-0.3
LU	0.9	0.3
MT	0.1	-0.4
NL	0.1	0.3
AT	-0.2	-0.1
PT	-0.5	-1.0
SI	-0.7	-0.7
SK	-0.3	-0.2
FI	-0.3	-0.3

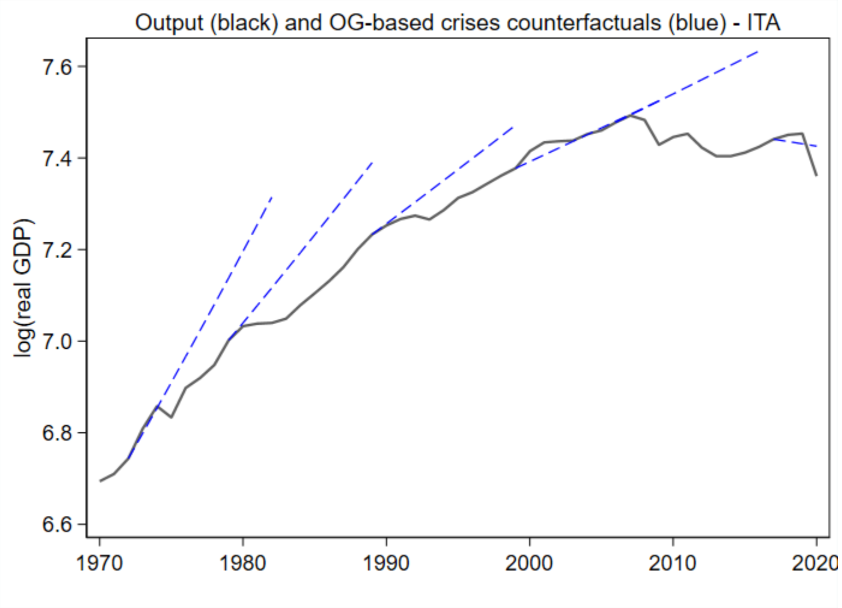
Source: European Fiscal Board

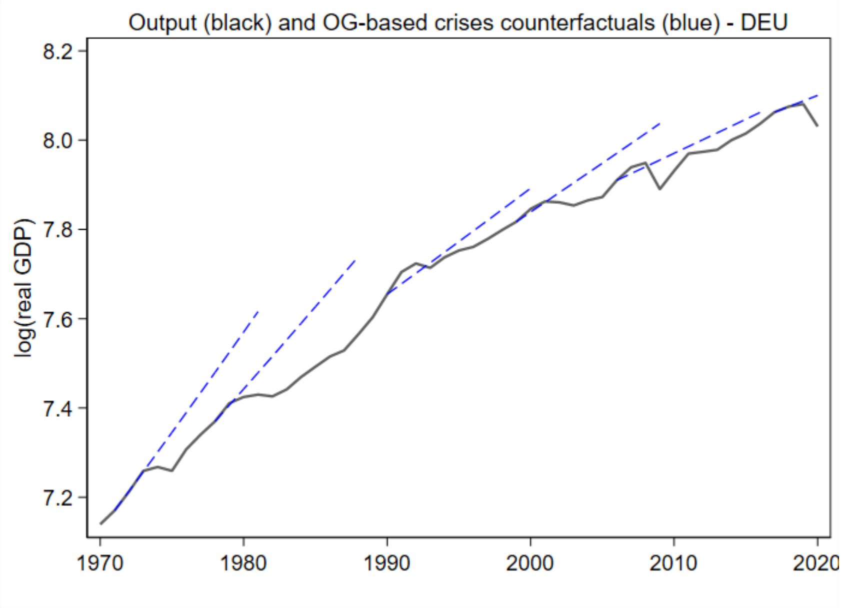
Notes: (1) Green, yellow and red correspond respectively to an assessment of ‘compliance’, ‘broad compliance’ and ‘risk of non-compliance’. (2) The assessment of compliance following the Commission’s ‘overall assessment’ also includes deviations over two years and the possible application of unusual event clauses. (3) ‘SB’ refers to the structural balance; ‘EB’ to the expenditure benchmark.

Looking back

Sustainability vs stabilisation

Major downturns produce significant scarring effects

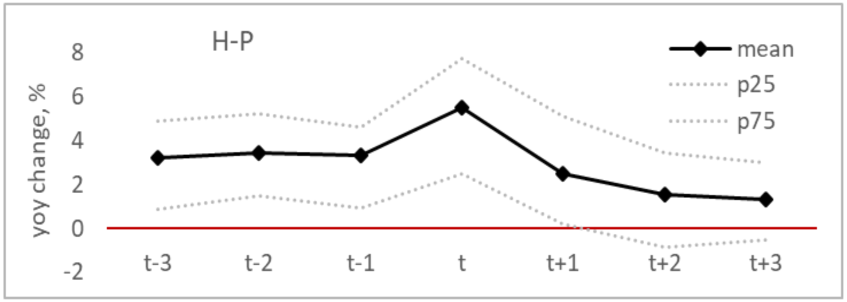




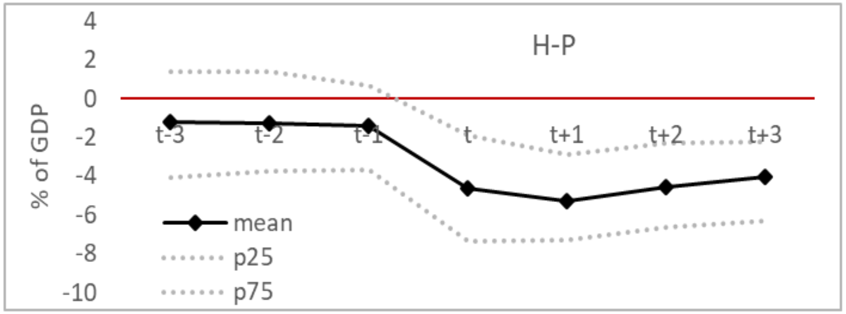
Source: Larch, M, P Claeys, W van der Wielen (2022) Scarring effects of major economic downturns: the role of fiscal policy and government investment, EFB conference 2022 https://ec.europa.eu/info/sites/default/files/economic_growth_after_major_economic_downturns_the_role_of_fiscal_policy_and_government_investment-paper.pdf

Sustainability vs stabilisation

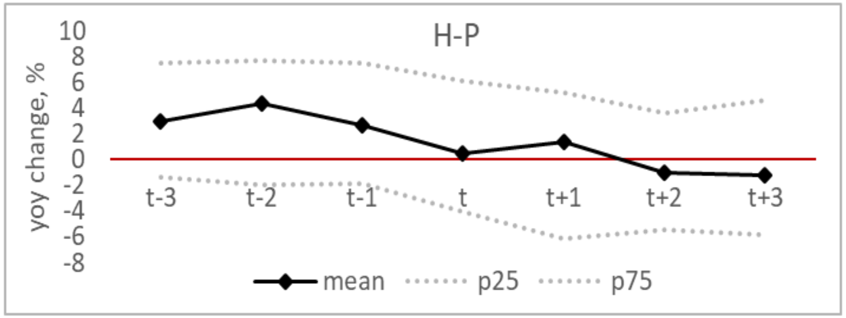
Current spending



Budget balance

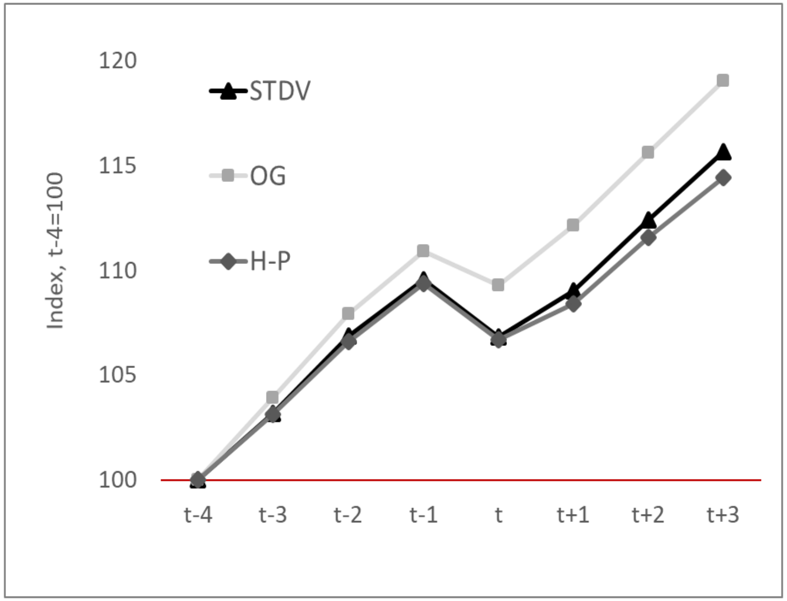


Government investment



26 OECD countries of which 14 EU, since 1970 or earliest available year (annual data): AUS, CAN, CHE, GBR, ISL, JPN, KOR, MEX, NOR, NLZ, TUR, USA , AUT, BEL, DEU, DNK, ESP, FIN, FRA, GRC, IRL, ITA, LUX, NLD, PRT, SWE

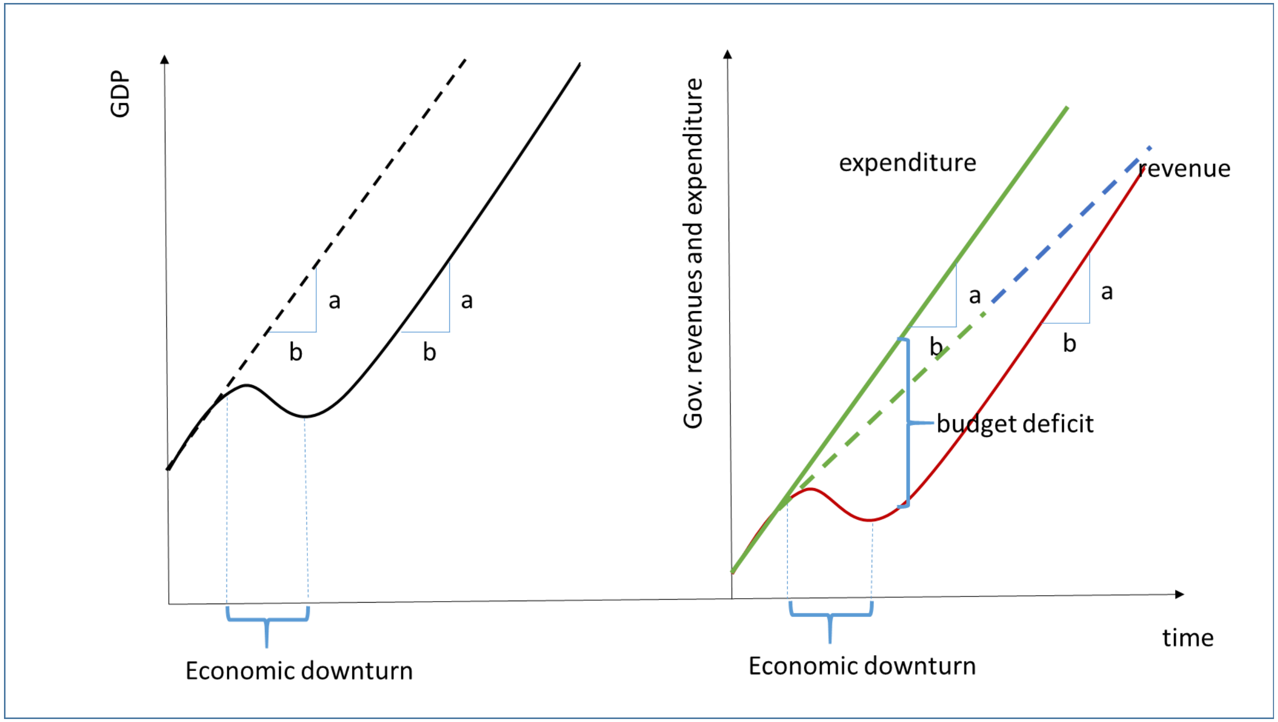
Real GDP



Locking back

Sustainability vs stabilisation

Possible solution safety margin. Examples: ‘Zalm rule’ in the NL, UK Treasury in 1980s and 1990s



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The early view: *Tie the hands of fiscal policy makers*

Debrun et al. (2008) Tied to the Mast? National Fiscal Rules in the European Union, Economic Policy

John William Waterhouse, Ulysses and the Sirens (1891), National Gallery of Victoria (Melbourne, Australia)

Looking ahead

Updated view: ***Hands of policy makers cannot be tied, but they need advise and ownership***

Pier Francesco Cittadini (ca. 1650) Ulysses and Circe (Private collection, Italy)

Looking forward

Changing assessment

2020

2011 und 2013 reforms of SGP strengthened the framework but…

Rules are to complex (too many operational rules, unobservable variables, etc.)

Too many objectives for one instrument (sustainability, stabillisation, quality of public finances)

Some MS with very high public debt. Not all MS take advantage of good times to build buffers

Equal treatment not ensured

2022

Not level of public debt is main problem but debt trajectory

Not enough leeway for public investment (green and digital transitions)

One-size–fits all rules; 1/20 the rules for debt reduction too demanding

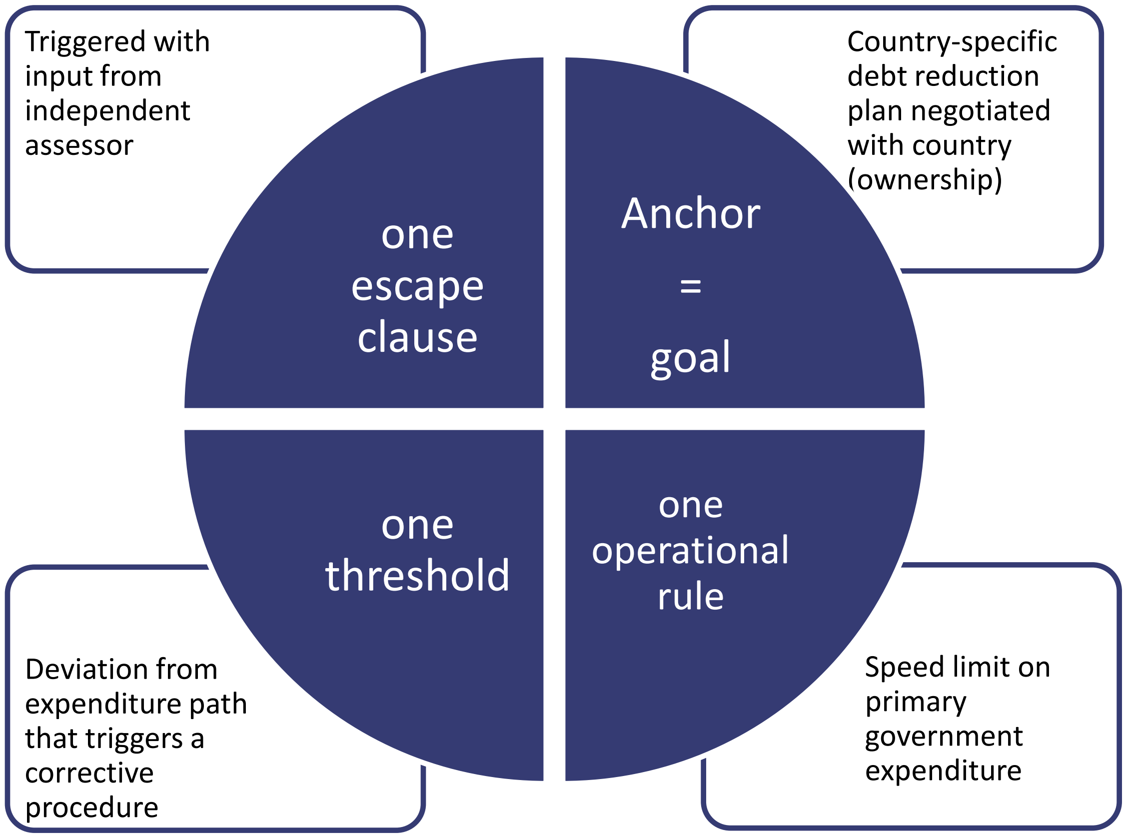
Different circumstances require differentiated treatment

Existing financial sanctions under SGP unrealistic

Ownership needs to be strengthened

Looking ahead

The stylised basic structure
(2^{nd} generation fiscal rules)



Looking ahead

Current rules	New rules	
MTO	Public debt ratio	**Anchor**
Annual benchmark ΔSB 0.5 % of GDP and or 1/20th of Dt - 60%	Bespoke path (4 or 7 years) towards plausible reduction of debt ratio	**Adjustment**
Deficit, debt, SB, EB	EB	**Operational rule**
Structural	Nominal (?)	**Metric**
Annual check	Check over medium term with notional control account	**Compliance**
Very restrictive conditions	Additional 3 years to complete fiscal adjustment	**Reforms and investment**
Unusual events, severe economic downturns, cycle, debt ratio, other relevant factors	One escape clause (EU-wide and national)	**Flexibility**

Aspiration and Reality (1)

Do the COM orientations provide the right answers?

- Important vs urgent
- Simple vs complex
- Equal treatment vs discrimination
- Multilateral vs bilateral
- Medium term orientation vs backloading of adjustment

Aspiration and Reality (2)

Will orientations find a majority in Council?

- First reactions confirm division of Member States
- 400+ questions raised on COM orientations
- Compromise by March 2023 difficult (some key elements of orientations require unanimity)

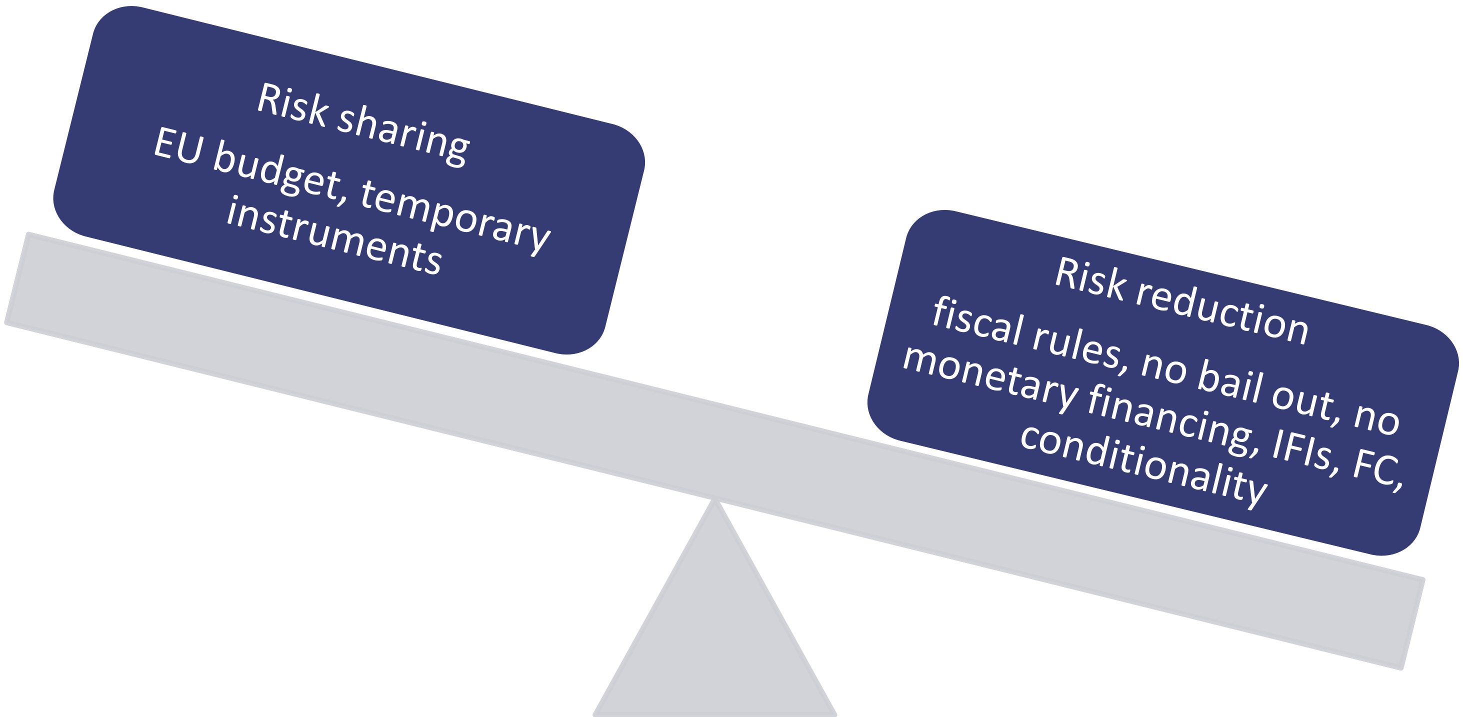
Aspiration and Reality (3)

What if Council cannot find a common landing zone?

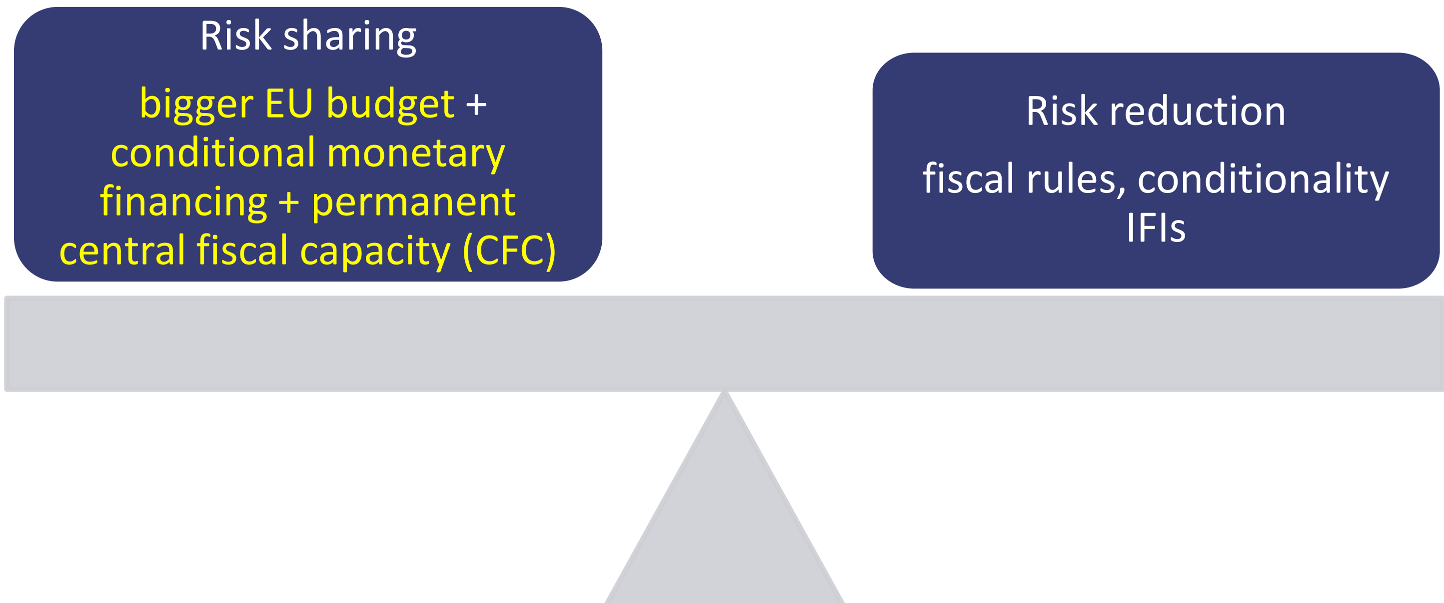
- Escape clause deactivated end 2023 (?)
- In spring 2023 COM and Council will propose/adopt new CSRs for 2024
- New interpretation of current laws by COM
- Gap between letter and practice of the SGP increases further
- What are the limits of a rules/law-based economic governance framework?

Looking ahead

Economic and Monetary Union (status quo)



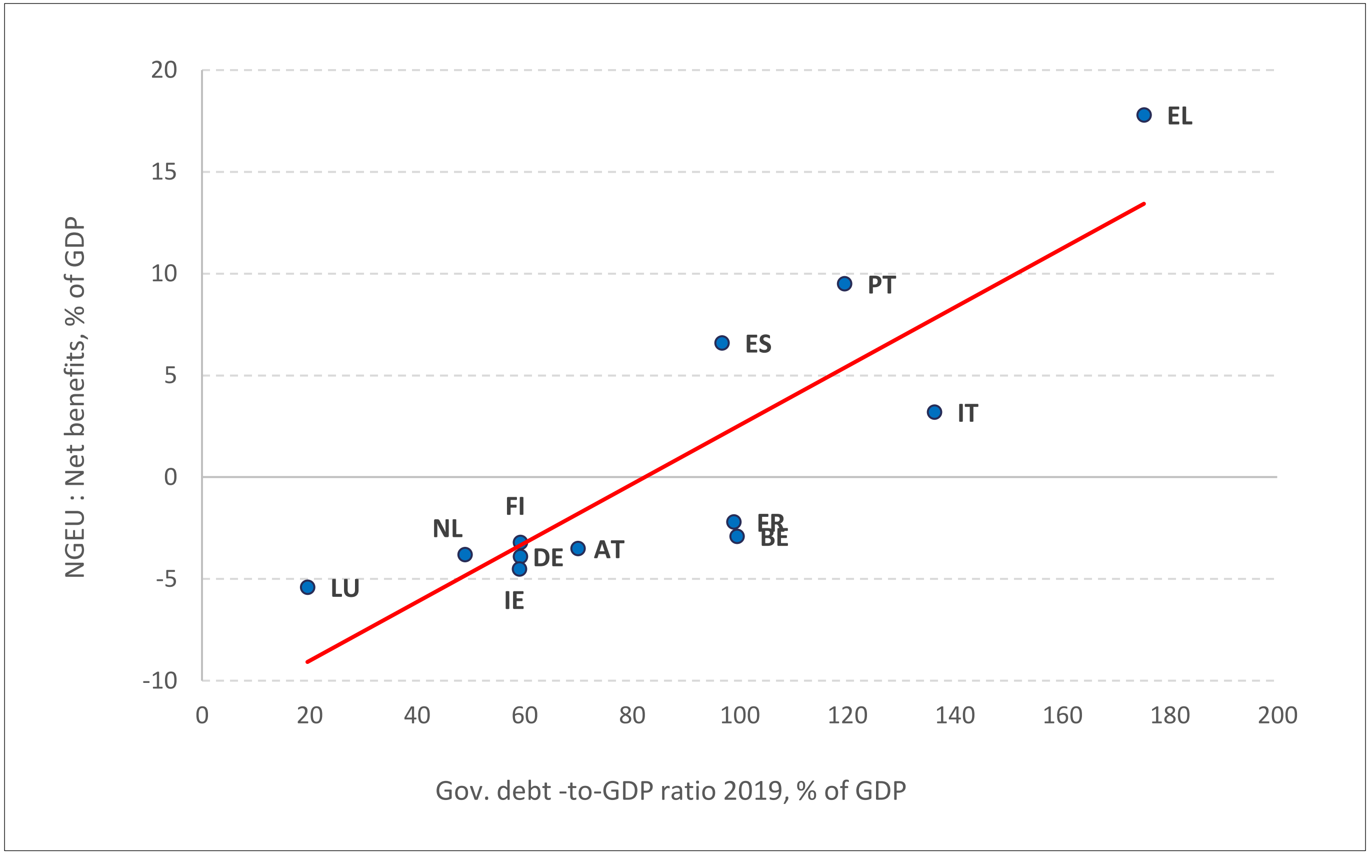
Economic and Monetary Union (as it should be)



Advantages and challenges of more risk sharing

- CFC would close important gap in current EMU architecture. Predicament well known for more than ½ a century
- Economies of scale, positive externalities
- **Why no or very little progress?**
- Distribution of risks across MS not random
- Moral hazard: ex-ante conditionality vs time consistency
- Risk sharing at EU level without proper political representation and accountability

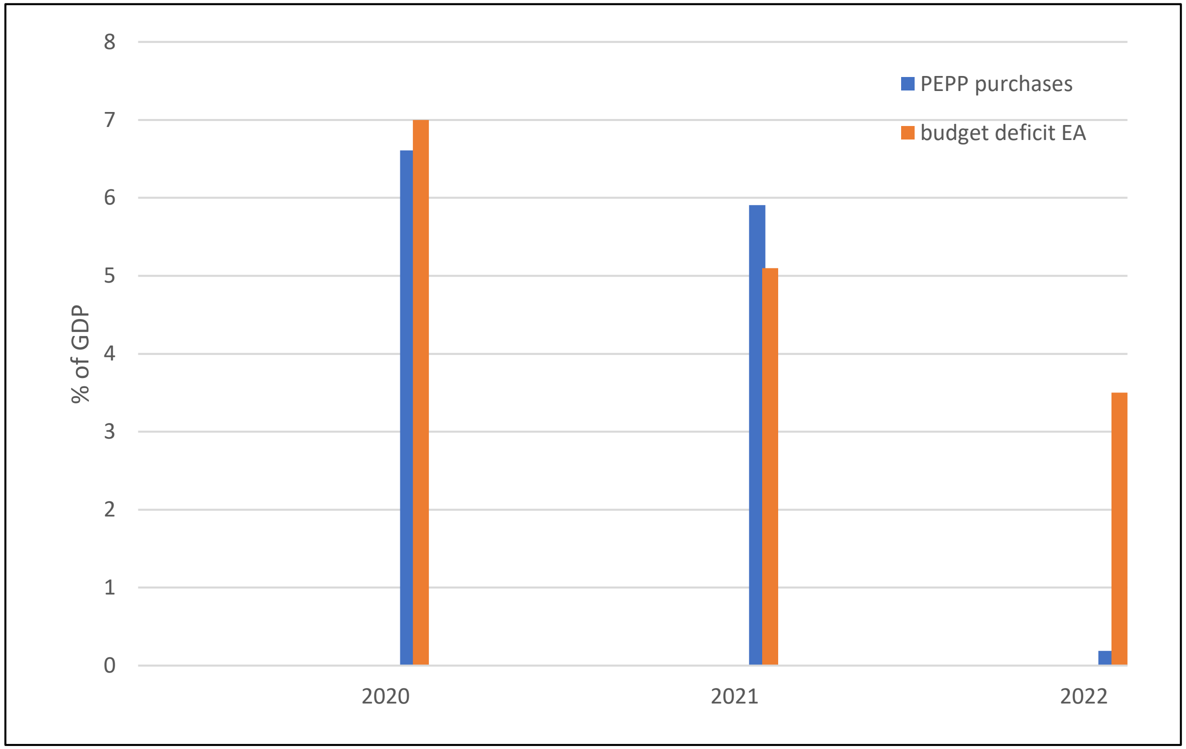
Advantages and challenges of more risk sharing



Source: European Commission

Looking ahead

Advantages and challenges of more risk sharing

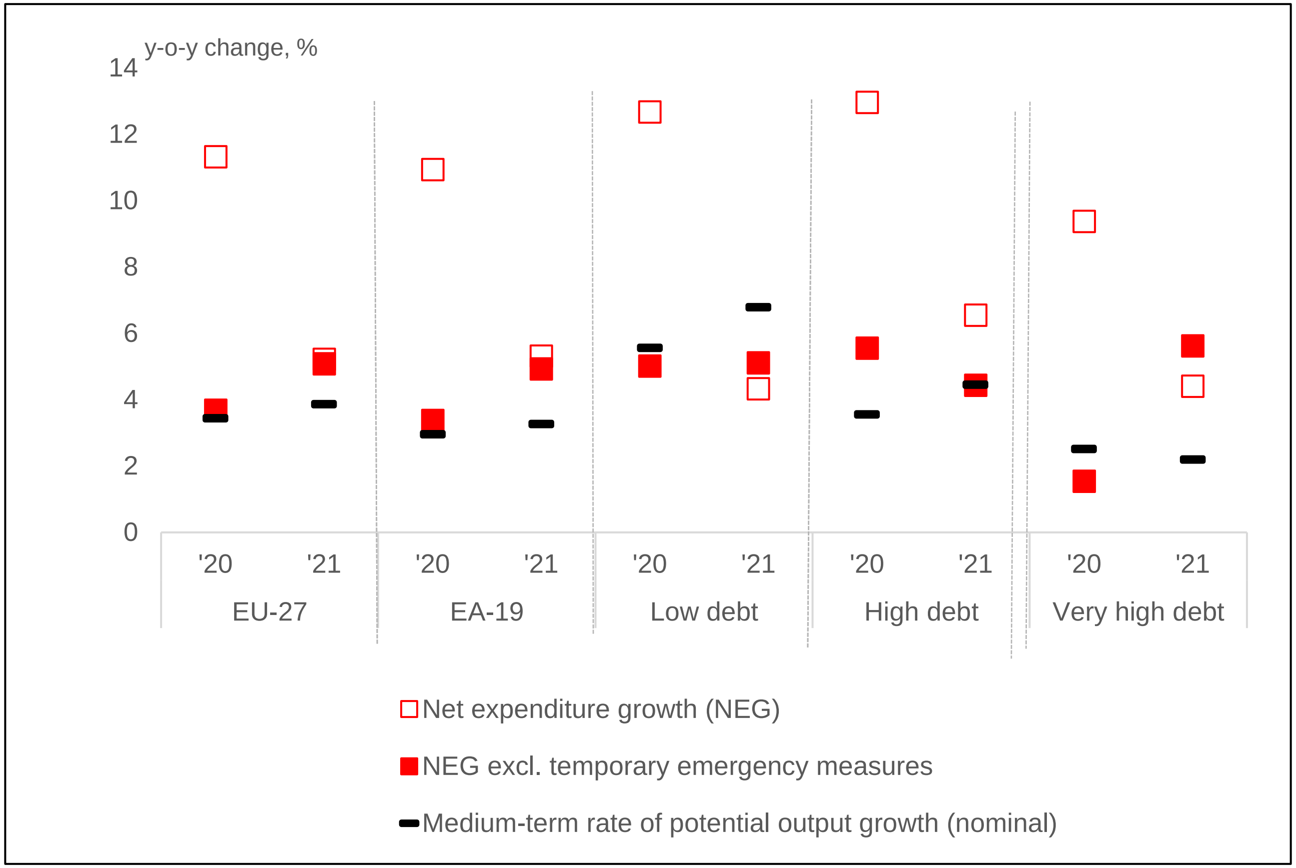


Source: ECB, European Kommission

Thanks for your time!

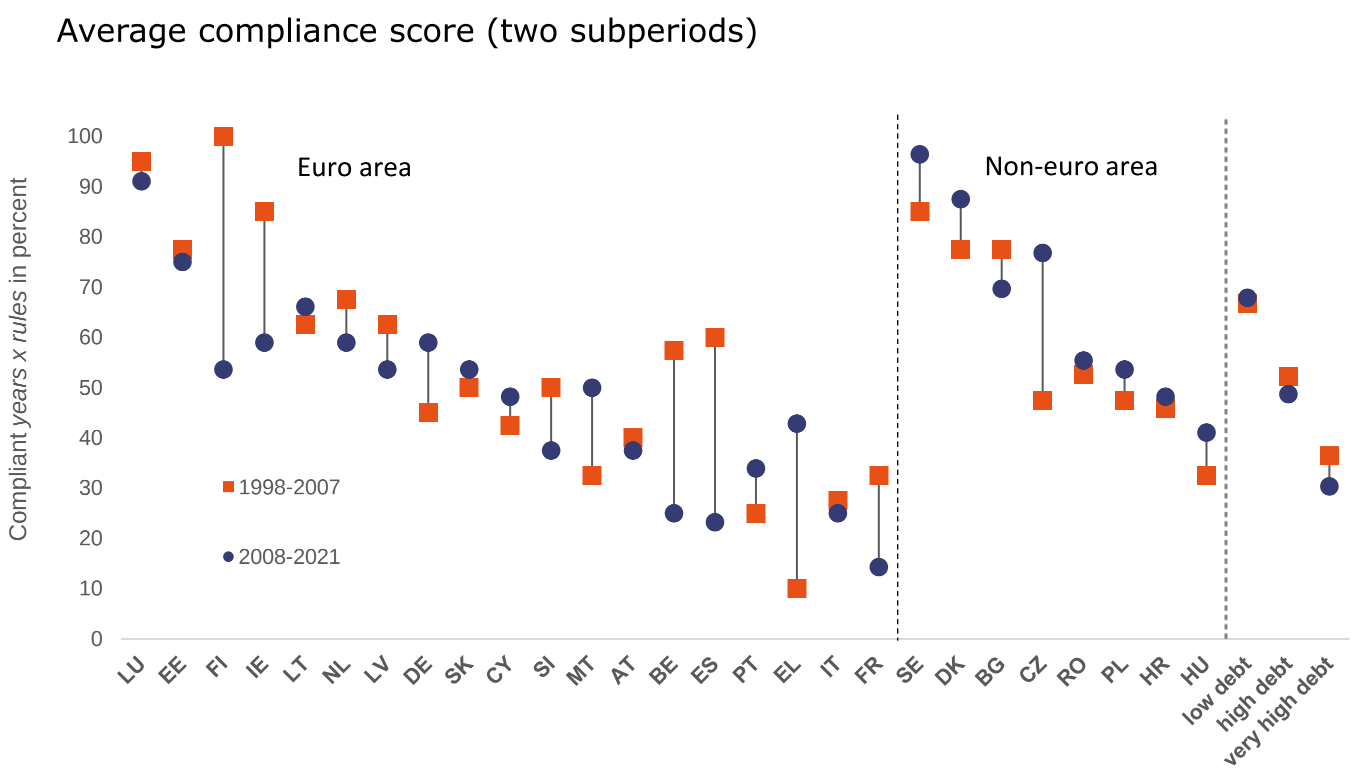
Visit the EFB at:
https://ec.europa.eu/european-fiscal-board

Persistence of old habits



Source: European Commission, own calculations

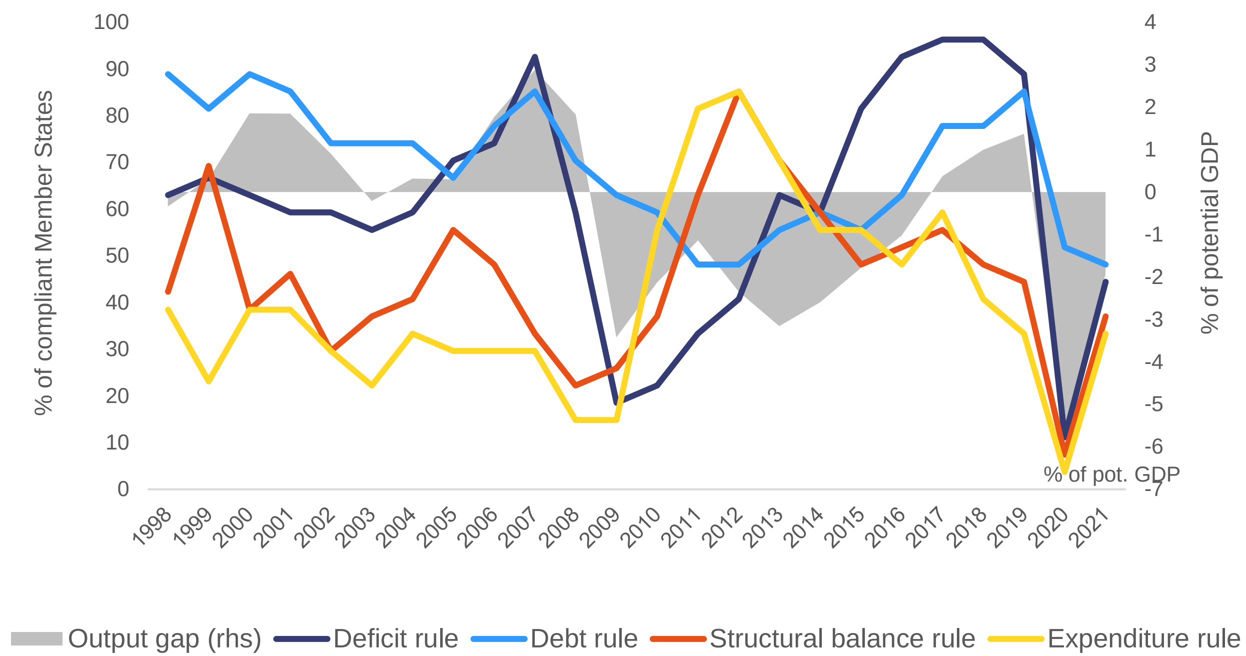
Bad luck or bad behaviour?



Source: Compliance tracker, Secretariat of the European Fiscal Board

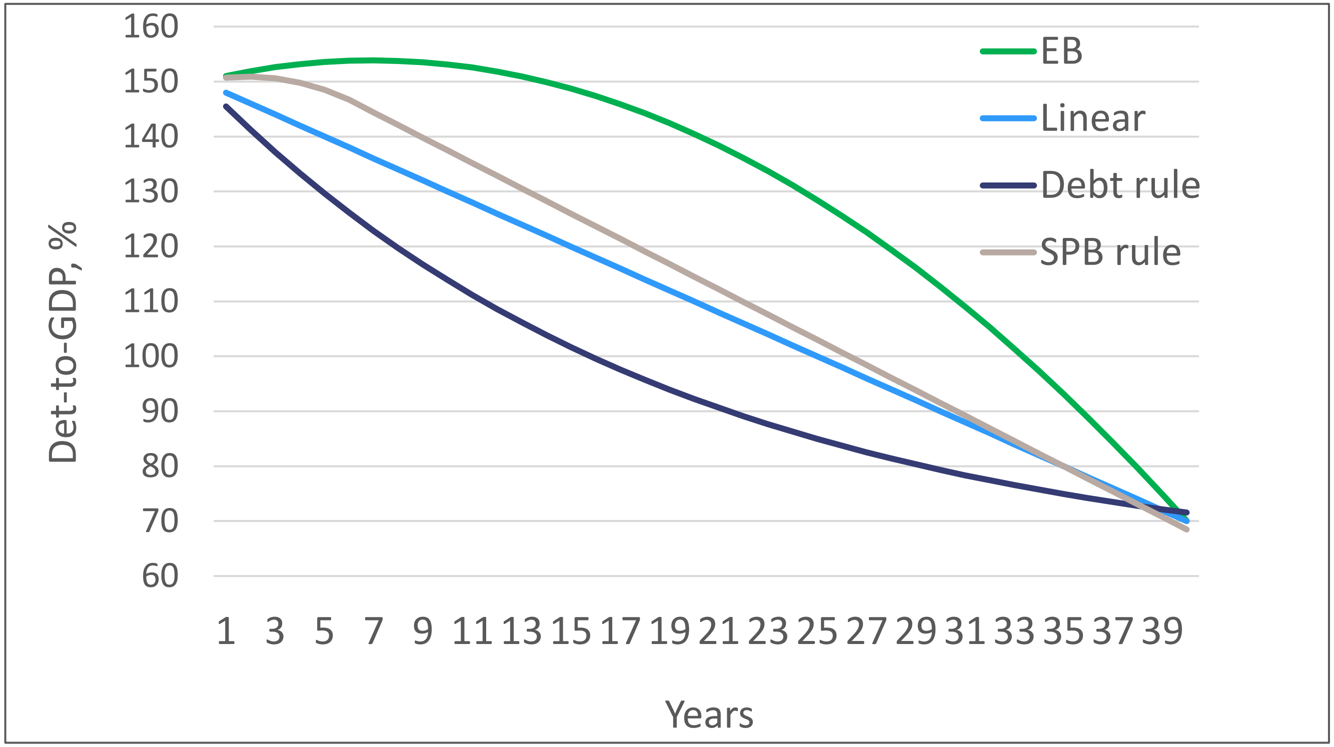
Background slides

Implementation: compliance with EU fiscal rules



Advantages and challenges of simplified SGP

The role of the expenditure benchmark



d_0 = 150% i_t = 5 yp_t= 5

- EB: speed limit on primary expenditure (g=5-0.35), d=70 in 40 years
- Debt rule: 1/20*(d_{t-1}- 60), yields d=70 in 40 years
- Linear debt reduction: d_t - d_{t-1}= (d_0-60)/40
- SPB: pb_t-pb_{t-1}= 0.5 until pb yields d=70 in 40 years

Advantages and challenges of simplified SGP

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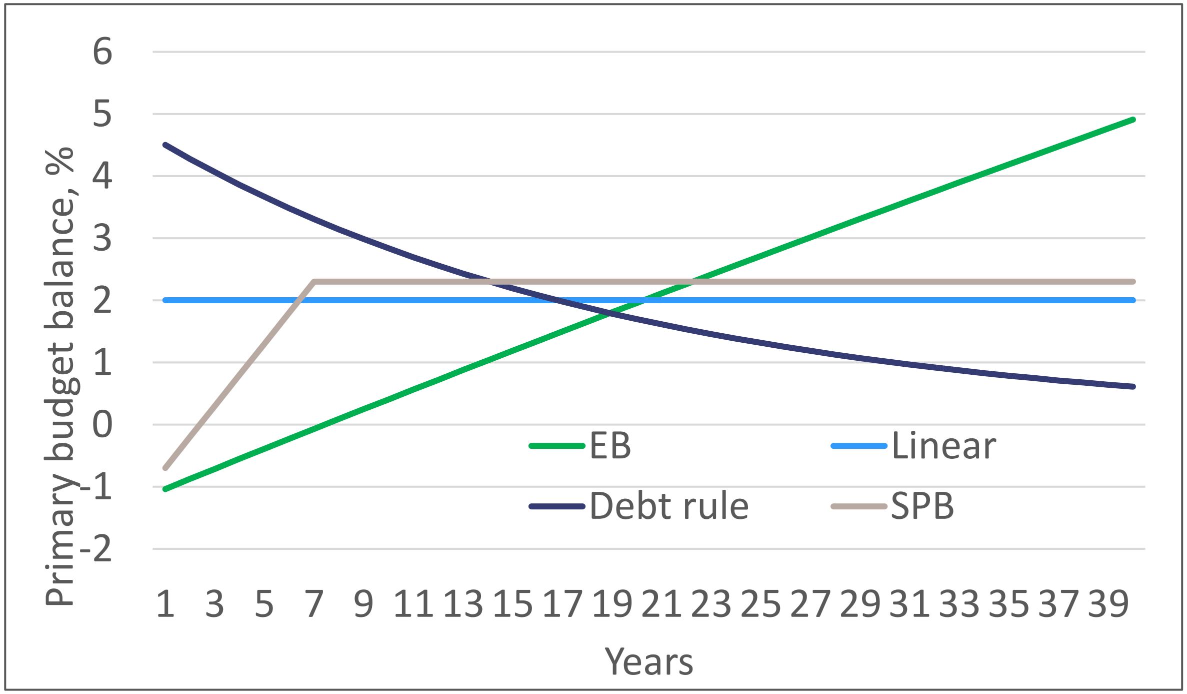

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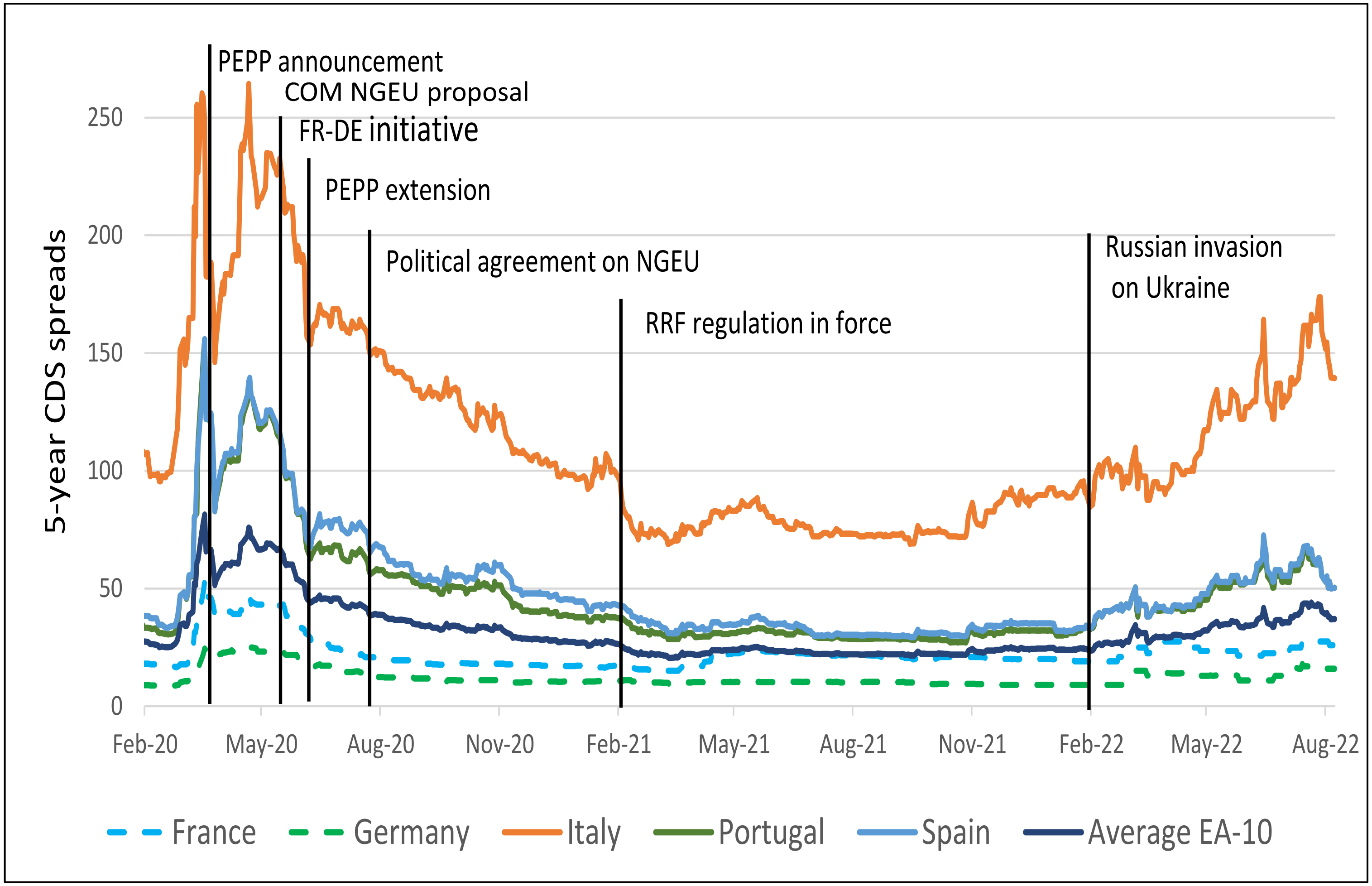
Advantages and challenges of more risk sharing



Source: Thomson Reuters DataStream